First National Stores Inc.

Finast®

1976 ANNUAL REPORT

FOR THE YEAR ENDED MARCH 27

The Annual Meeting of Shareholders will be held at the Company's Executive Offices, 5 Middlesex Avenue, Somerville, Massachusetts on Monday, June 28, 1976, 10:00 A.M. Eastern Daylight Time. All Shareholders are cordially invited to attend.

Financial Highlights

	52 Weeks ended March 27, 1976	52 Weeks ended March 29, 1975*
Sales	**$974,086,000**	$934,803,000
Income (loss) before extraordinary credit	**(1,502,000)**	4,179,000
Extraordinary credit	**—**	1,595,000
Net income (loss)	**(1,502,000)**	5,774,000
Per share of common stock:		
Income (loss) before extraordinary credit	**(1.32)**	3.35
Extraordinary credit	**—**	1.28
Net income (loss)	**(1.32)**	4.63
Capital expenditures	**13,082,000**	9,781,000
Working capital	**9,567,000**	18,875,000
Total assets	**117,017,000**	123,530,000
Stockholders' equity	**61,753,000**	64,374,000
Book value per share	**54.60**	56.93
Number of supermarkets (at year end)	**264**	274
Average shares outstanding for purposes of computing earnings per share	**1,136,632**	1,246,315
Shares outstanding (at year end)	**1,131,071**	1,130,787

* Certain amounts as previously reported have been restated to reflect the retroactive application of the change in accounting for self-insurance.

Common Stock

Three dividends of twenty-five cents per share were declared in fiscal 1975 which were paid on September 12, 1974, December 6, 1974 and April 7, 1975.

Four dividends of twenty-five cents per share were declared in fiscal 1976 which were paid on July 21, 1975, October 15, 1975, December 19, 1975 and March 19, 1976.

The following table shows the high and low quarterly sales prices of the Company's common stock for fiscal years 1975 and 1976 on the Boston Stock Exchange.

Fiscal Year		High	Low
1975	First quarter (March 31 through June 29)	26	23
	Second quarter (June 30 through Sept. 28)	26¾	20½
	Third quarter (Sept. 29 through Dec. 28)	27	20⅞
	Fourth quarter (Dec. 29 through March 29)	24½	20¾
1976	First quarter (March 30 through June 28)	30	23⅛
	Second quarter (June 29 through September 27)	30⅛	26
	Third quarter (September 28 through December 27)	25	20
	Fourth quarter (December 28 through March 27)	24⅛	18⅞

Copies of the Company's Annual Report (Form 10-K) to be filed with the Securities and Exchange Commission may be obtained without charge upon request to Treasurer's Office, First National Stores Inc., 5 Middlesex Avenue, Somerville, Massachusetts 02143.

To Our Shareholders:

Following the encouraging results of fiscal 1975, fiscal 1976 can only be considered a disappointment. There is no other way to characterize the loss of $1,502,000, irrespective of the fact that the Company bore the burden of a difficult strike which impacted our performance throughout the year.

Sales for fiscal 1976 were $974,086,000 versus $934,803,000 in fiscal 1975, an increase of 4.2%. At year end the Company was operating 264 supermarkets compared with 274 at the end of the prior fiscal year. Our supermarkets continue to serve the six New England states as well as the metropolitan New York area including Northern New Jersey.

The net loss for fiscal 1976 of $1,502,000 equalled $1.32 per share. Net earnings for fiscal 1975 were $5,774,000 or $4.63 per share including an extraordinary credit of $1,595,000 or $1.28 per share resulting from the utilization of net operating loss carry-forwards.

Results for both years include credits relating to store closings; $1,173,000 in fiscal 1976 and $449,000 in fiscal 1975. These credits arose from the Company's policy of recognizing gains on disposals of properties in the period realized and from better than anticipated results experienced in disposing of closed store leases net of charges for additional planned store closings. Also net income for fiscal 1975 includes a credit of $4,277,000 or $3.43 per share as a result of reduction in inventory levels which caused a liquidation of LIFO inventory quantities.

The first quarter of fiscal 1976 showed a loss of $3,289,000 directly attributable to a five-week strike which closed our Somerville Distribution Center, the service area for over half the Company. More devastating effects were avoided because we kept all of our stores open during the strike, a massive and very expensive effort. Indirect costs such as loss of sales, and dislocations in inventory and marketing thrust cannot be accurately estimated but certainly existed. The second quarter was devoted to recovering from the effects of the strike and a budgeted small profit of $324,000 was achieved. We felt it necessary in the third quarter to increase our promotional activities to avoid a lag in sales. We also opened four stores in the quarter, always an expensive project. These activities were a necessary investment which contributed to the loss for the quarter of $1,702,000.

A fiscal 1976 fourth quarter profit of $3,165,000 was insufficient to offset the prior nine month loss of $4,667,000. It did, however, compare well to the fourth quarter in the previous year. While fourth quarter net profit in fiscal 1975 was $5,406,000 it included an extraordinary credit of $1,519,000 resulting from the utilization of net operating loss carry-forwards and a non-recurring increase in net income of $3,179,000 caused by the liquidation of LIFO inventory quantities carried at the lower cost prevailing in prior years.

Capital expenditures in fiscal 1976 were $13,082,000 versus $9,781,000 in fiscal 1975. Five new stores were opened. In addition, four stores received major remodels and many others were modernized. The return on investment from our remodelling program has been most satisfactory and confirms our belief in the store improvement program initiated in 1974. The program continues in the current year with three major remodels and several modernizations already underway. In addition, leases for four new stores have been negotiated. We will continue to be extremely cautious in accepting new locations, confining them to development within our existing market area and to replacement of outmoded units.

We continue to modernize and broaden the services offered our customers. We opened two in-store pharmacies during the year, five new deli departments, a new liquor store and six new in-store bakeries. A growing number of specialty cheese cases, foreign food line additions and flower departments are expanding our appeal to the customer. We increased our non-foods emphasis and have met with success especially in our health and beauty aids program. Our bakery in East Hartford, Connecticut, was fully on line by the middle of the year and is proving to be a satisfactory investment. As well as providing our stores with a complete range of private label baked goods, over 10% of its sales are to outside customers.

During the year we modified the Company's Pension Plan both to update benefits to our employees and to bring it in line with the Employee Retirement Income Security Act commonly known as ERISA. It is important to note that the Company's Pension Plan is funded and no contributions have had to be made to it since fiscal 1966.

In recent years, food prices led the inflationary spiral, and supermarket operating cost increases lagged somewhat behind. This tended to disguise the seriousness of the cost/sales relationships in the industry. In the last quarter of our fiscal year and into the new year, food prices settled into a relatively level pattern while costs of labor, utilities, taxes and supplies continue to rise. Although we expect a moderate inflation in food prices to begin again before year end, it should be considerably below the experience of prior years. Therefore, a premium must be placed on the ability to improve real sales and control costs with great care and ingenuity. This situation is evidenced by the increased competition which has manifested itself in many parts of the country. It is especially important in the Northeast where sales do not have the bouyancy shown elsewhere due to our higher unemployment situation and our below average population increases. We are fortunate that much of what we have done in the last few years has prepared our business to cope with just such a set of circumstances. Our systems, training programs, store census, services and marketing have been refined to develop a lean, cost conscious, while at the same time, sales oriented management group. We are thus equally prepared to respond to the difficult competitive and operating conditions of a dull sales market or to profit from the opportunities which can be presented by a recovered economy. There is great energy, capability and loyalty in the First National family which will continue to direct itself towards moving your company forward.

Respectfully submitted,

William T. French
William T. French
Chairman of the Board

Alan L. Haberman
Alan L. Haberman
President and Chief Executive Officer

FIRST NATIONAL STORES INC. AND SUBSIDIARIES

Consolidated Statements of Income (Loss) and Retained Earnings

	52 Weeks ended	
	March 27, 1976	March 29, 1975 (Note 10)
Sales	**$974,086,000**	$934,803,000
Costs and expenses:		
Cost of sales (Note 3), warehousing, transportation and store occupancy expenses	**819,723,000**	790,220,000
Direct selling, advertising, general and administrative expenses	**150,802,000**	134,055,000
Depreciation and amortization (Note 2)	**7,450,000**	6,731,000
Estimated credits related to store closings (Notes 2 and 4)	**(1,173,000)**	(449,000)
	976,802,000	930,557,000
Operating income (loss)	**(2,716,000)**	4,246,000
Other income (expense):		
Interest income	**1,367,000**	2,487,000
Interest expense including imputed interest of $355,000 in 1976 and $481,000 in 1975	**(395,000)**	(933,000)
Other	**242,000**	199,000
	1,214,000	1,753,000
Income (loss) before federal and state income taxes	**(1,502,000)**	5,999,000
Federal and state income taxes (Notes 2 and 7)	**—**	1,820,000
Income (loss) before extraordinary credit	**(1,502,000)**	4,179,000
Extraordinary credit—utilization of net operating loss carryforward (Note 7)	**—**	1,595,000
Net income (loss)	**(1,502,000)**	5,774,000
Retained earnings at beginning of year, as previously reported		44,576,000
Add—Effect of change in accounting method (Note 10)		434,000
Retained earnings at beginning of year, restated	**49,877,000**	45,010,000
Cash dividends declared—$1.00 per share in 1976 and $.75 per share in 1975	**(1,130,000)**	(907,000)
Retained earnings at end of year	**$ 47,245,000**	$ 49,877,000
Per share of common stock (Note 2):		
Income (loss) before extraordinary credit	**$(1.32)**	$3.35
Extraordinary credit	**—**	1.28
Net income (loss)	**$(1.32)**	$4.63

FIRST NATIONAL STORES INC. AND SUBSIDIARIES

Consolidated Balance Sheets

	March 27, 1976	March 29, 1975 (Note 10)
Assets		
Current assets:		
Cash	$ 2,242,000	$ 5,431,000
Short-term investments, at cost which approximates market	16,595,000	22,003,000
Accounts receivable, less allowance for doubtful accounts—$500,000 in 1976 and $300,000 in 1975	4,832,000	5,776,000
Amounts due on sale of equipment	—	4,102,000
Inventories (Notes 2 and 3)	35,498,000	32,822,000
Prepaid expenses and other current assets	2,361,000	2,971,000
Total current assets	61,528,000	73,105,000
Fixed assets, at cost (Note 2):		
Land	3,437,000	3,367,000
Buildings owned	12,981,000	11,938,000
Store fixtures and equipment	75,710,000	69,279,000
Store leasehold improvements	17,594,000	16,046,000
Other leaseholds, machinery and equipment	18,200,000	17,642,000
	127,922,000	118,272,000
Less—Accumulated depreciation and amortization (Note 2)	74,378,000	70,257,000
	53,544,000	48,015,000
Other assets and deferred charges	1,945,000	2,410,000
	$117,017,000	$123,530,000
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 35,744,000	$ 38,583,000
Dividends payable	—	283,000
Accrued expenses	15,123,000	13,904,000
Current portion of accrued costs related to store closings (Notes 2 and 4)	1,094,000	1,460,000
Total current liabilities	51,961,000	54,230,000
Accrued costs related to store closings (Notes 2 and 4)	2,185,000	3,525,000
Other deferred credits	1,118,000	1,401,000
Stockholders' equity (Notes 1, 5 and 6):		
Common stock, without par value:		
Authorized—5,000,000 shares		
Issued—1,655,268 shares	31,875,000	31,874,000
Retained earnings	47,245,000	49,877,000
	79,120,000	81,751,000
Less—Treasury stock, at cost—524,197 shares in 1976 and 524,481 shares in 1975	17,367,000	17,377,000
	61,753,000	64,374,000
Lease commitments (Note 8)		
	$117,017,000	$123,530,000

FIRST NATIONAL STORES INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Financial Position

	52 Weeks ended	
	March 27, 1976	March 29, 1975 (Note 10)
Financial resources were provided by:		
Operations:		
Income (loss) before extraordinary credit	$ (1,502,000)	$ 4,179,000
Expenses not requiring (providing) working capital in the current period:		
Depreciation and amortization (Note 2)	7,450,000	6,731,000
Estimated credits related to provision for store closings	(569,000)	(266,000)
Other, principally gain on sale of closed store fixed assets in 1976 and provision for deferred compensation in 1975	(751,000)	634,000
Working capital provided by operations	4,628,000	11,278,000
Extraordinary credit—utilization of net operating loss carryforward	—	1,595,000
Proceeds from disposal of fixed assets	1,376,000	2,192,000
	6,004,000	15,065,000
Financial resources were used for:		
Additions to fixed assets	13,082,000	9,781,000
Acquisition of 235,966 shares of treasury stock	—	6,533,000
Reduction in long-term portion of accrued costs related to store closings	921,000	1,092,000
Reduction of long-term debt	—	6,791,000
Cash dividends declared	1,130,000	907,000
Other	179,000	(40,000)
	15,312,000	25,064,000
Decrease in working capital	(9,308,000)	(9,999,000)
Working capital at beginning of year	18,875,000	28,874,000
Working capital at end of year	$ 9,567,000	$18,875,000
Analysis of changes in elements of working capital:		
Increase (decrease) in current assets:		
Cash and short-term investments	$ (8,597,000)	$ (3,817,000)
Accounts receivable	(944,000)	447,000
Amounts due on sale of equipment	(4,102,000)	4,102,000
Inventories (Notes 2 and 3)	2,676,000	(13,273,000)
Prepaid expenses and other current assets	(610,000)	128,000
	(11,577,000)	(12,413,000)
(Increase) decrease in current liabilities:		
Accounts payable and dividends payable	3,122,000	(3,098,000)
Accrued expenses	(1,219,000)	2,271,000
Current portion of long-term debt	—	3,267,000
Current portion of accrued costs related to store closings (Note 4)	366,000	(26,000)
	2,269,000	2,414,000
Decrease in working capital	$ (9,308,000)	$ (9,999,000)

Notes to Financial Statements

Note 1—Principal Stockholder

Madison Fund, Inc., a diversified closed-end investment company, owns 61.6% of the outstanding shares of the Company.

Note 2—Summary of Significant Accounting Policies

The accounting and reporting policies of First National Stores Inc. conform with generally accepted accounting principles. The following describes the more significant of those policies:

Consolidation policy

All subsidiaries of the Company are included in the consolidated financial statements. Significant intercompany transactions and balances are eliminated.

Inventories

Inventories are stated at cost or market, whichever is lower, cost being determined substantially by the last-in, first-out method of inventory valuation (see Note 3).

Depreciation and amortization

For financial statement purposes, depreciation and amortization are computed principally by the straight-line method. For tax purposes, accelerated depreciation methods have been used. Estimated useful lives are as follows:

Buildings owned	20-50 years
Store fixtures and equipment	3-10 years
Store leasehold improvements	10-25 years
Other leaseholds, machinery and equipment	3-25 years

Maintenance and repairs

Expenditures for maintenance, repairs and minor renewals are expensed in the year in which incurred, while betterments and major renewals are capitalized.

Store closing costs

Estimated future expenditures related to store closings, principally rents, real estate taxes and other occupancy costs, net of estimated income from existing sublease arrangements, together with the unamortized value of leasehold improvements and store equipment, are charged to income when the decision is made to close a store. Gains on dispositions of store properties are recognized when realized (see Note 4).

Pre-opening expenses

All expenses incurred in connection with the opening of stores are charged to income as incurred.

Income taxes

The provision for income taxes in the financial statements relates to the items of income and expense included in such statements. Deferred income taxes are provided when necessary to recognize the effects of timing differences which result when items of income or expense are recognized in a different period for tax purposes. The investment tax credit arising from the purchase and lease of qualifying property additions is recognized under the "flow through" method (see Note 7).

Net income (loss) per share

The weighted average number of shares used to compute net income (loss) per share includes the shares allotted but not yet issued under the Company's previous executive incentive compensation plan (see Note 6) and, if the effect is dilutive, the shares issuable under the stock option plan (see Note 5).

Pensions

The Company maintains a trusteed noncontributory pension plan for employees who are not covered by union pension plans. Actuarial gains, resulting principally from the transfer of employees to various union plans and appreciation in the fund, are being amortized over ten-year periods from the dates of occurrence (see Note 9).

Note 3—Inventories

Inventories stated under the LIFO method were $27,901,000 and $28,070,000 less than current average costs at March 27, 1976 and March 29, 1975, respectively.

During fiscal 1975, there was a reduction in inventory levels which caused a liquidation of LIFO inventory quantities carried at the lower costs prevailing in prior years. As a result, net income and net income per share in fiscal 1975 were increased by $4,277,000 and $3.43, respectively.

Note 4—Costs Related to Store Closings

At March 27, 1976 and March 29, 1975 accrued costs related to store closings were $3,279,000 and $4,985,000, respectively, net of imputed interest of $804,000 in 1976 and $1,498,000 in 1975.

Estimated payments of the accrued costs, less imputed interest, during each of the next five fiscal years are as follows: 1977 $1,094,000; 1978 $542,000; 1979 $402,000; 1980 $315,000; and 1981 $135,000.

Estimated credits related to store closings, as shown on the statement of income, are principally the result of recognizing gains on the disposal of closed store properties and equipment in the period such gains are realized together with the net effect of current estimates of store closings and lease termination costs.

Note 5—Stock Options

Under the Company's 1971 Stock Option Plan, options may be granted to key employees to purchase common stock at not less than the fair market value on the date of grant. Of the options outstanding on March 27, 1976 options for 9,750 shares were then exercisable. At March 27, 1976, 34,250 shares were available for future grant through May 11, 1976. The Board of Directors has approved a five year extension of the 1971 Plan, subject to shareholder approval.

The following table summarizes the stock option activity during 1976.

	Number of shares	Price per share
Options outstanding at beginning of year	30,500	$ 17.50 to $26.25
Granted	4,500	$ 25.00 to $30.00
Expired or terminated	(4,250)	$ 17.50 to $26.25
Options outstanding at end of year	30,750	$19.875 to $30.00

Note 6—Incentive Compensation Plans

The stockholders approved in 1970 an Executive Incentive Compensation Plan under which 6% of pre-tax income, as defined, was available for awards to eligible participants in any year through fiscal 1975 in which such income exceeded $3,000,000 and cash dividends on common stock were paid. In accordance with the provisions of that Plan, no compensation was recorded for fiscal years 1972 through 1974. Under previous awards, 284 shares of treasury stock were issued during 1976 and 979 shares in 1975. The difference between the amount of compensation accrued and the average cost of treasury shares so issued was credited to the common stock account in the amounts of $1,000 and $2,000 in 1976 and 1975, respectively. At March 27, 1976, 5,561 shares had been allotted and will be issued in future years.

The Board of Directors and shareholders have adopted a new Executive Incentive Compensation Plan and the 1970 Plan has been terminated. Under the new Plan, 6% of pre-tax income, as defined, will be available for cash awards to eligible participants. Such

Notes to Financial Statements (continued)

amount cannot exceed the aggregate of the base compensation of the participants or an amount which would reduce defined pre-tax income below $4,000,000. In fiscal 1975, $590,000 was provided under this Plan, and is payable over five years with interest at the prime rate from the date of the first payment.

Effective October 10, 1974, the Board of Directors adopted, and the shareholders subsequently approved, a Performance Improvement Plan which authorized an aggregate of 100,000 "performance units" which may be granted to key executives. At March 27, 1976, 76,500 units had been granted. The Plan provides for incentive compensation essentially equal to the amount by which the market value, as defined, of the performance units at the distribution date exceeds a base value which, for the units granted is $27. Compensation under the Plan is payable beginning three years from the date of grant. At March 27, 1976, no compensation was accruable under this Plan.

Note 7—Income Taxes

At March 27, 1976, the Company had approximately $13,800,000 of tax basis net operating loss carryforwards which expire principally in 1979 and 1981. For financial accounting purposes, the operating loss carryforwards are approximately $12,400,000. The excess of the tax basis carryforwards results principally from the excess of accelerated depreciation used for tax purposes over estimated costs related to store closings which are not currently deductible and other differences between tax and accounting income; the tax effect of these differences will be applied to deferred tax accounts to the extent they are realized.

In addition, the Company had a tax basis investment credit carryover of approximately $3,000,000 expiring at various dates through 1983. For financial accounting purposes the investment credit carryover is $1,700,000; the difference results from the utilization in the 1975 provision of $1,300,000 applicable to property additions in 1975 and prior years.

A reconciliation of the fiscal 1975 statutory federal income tax rate on income before income taxes to the effective rate follows:

Statutory rate	48%
Less—effect of investment tax credits	(22)
Add—provision for state income taxes	4
Effective rate	30%

Note 8—Lease Commitments

At March 27, 1976, the Company was committed under long-term leases for operating stores and other real property used in the business. These leases expire principally within ten to fifteen years and generally contain renewal options. The Company also leases motor vehicles and equipment. Costs related to closed stores, including an amount for future rent costs to the estimated disposal dates, are accrued in the financial statements.

The Company has determined that substantially all real estate leases and certain equipment leases are "non-capitalized financing leases" as defined by the Securities and Exchange Commission. Certain of the data set forth below relating to such leases for 1975 has been restated.

A summary of rent expense, excluding rents charged to accrued costs related to store closings, follows (000 omitted):

	1976	1975
Non-capitalized financing leases:		
Minimum rent	$11,500	$10,733
Additional rent based on sales	754	594
	$12,254	$11,327
All leases:		
Minimum rent	$13,756	$12,939
Additional rent based on sales	754	594
	$14,510	$13,533

Minimum annual rentals at March 27, 1976 under noncancellable leases for open store properties and leased equipment are as follows for the years or periods indicated (000 omitted):

Fiscal year	All leases	Financing leases
1977	$12,776	$11,771
1978	11,743	11,044
1979	10,451	9,763
1980	9,246	8,617
1981	8,379	7,810
1982-1986	30,059	29,279
1987-1991	20,215	20,215
1992-1996	9,762	9,762
After 1996	2,808	2,808

The present value of minimum lease commitments for non-capitalized financing leases is presented in the following table. Commitments for gross leases have been reduced by estimated real estate taxes and other operating expenses included in the gross payments.

	1976	1975
	(000 omitted)	
Operating store properties	$52,300	$49,900
Motor vehicles, equipment and other property	8,100	3,400
	$60,400	$53,300

The weighted average interest rates used in these present value calculations were 8% for 1976 and 7.6% for 1975. The ranges of rates used were from 3.75% to 10% in both 1976 and 1975 for store properties. For motor vehicles, equipment and other property the ranges were 5.25% to 12% in 1976 and 5.25% to 11.25% in 1975.

If, instead of recording rent expense, all financing leases were capitalized, related assets were amortized on a straight-line basis and interest costs were accrued on the basis of the outstanding lease liability, the impact on income (loss) before extraordinary credit would be to increase such loss in 1976 by approximately $375,000 and to decrease such income by approximately $285,000 in 1975. Included in this computation for 1976 was amortization of $5,600,000 and interest cost of $4,600,000; for 1975, the comparable amounts were $4,800,000 and $4,200,000, respectively.

Note 9—Pensions

The assets of the Company's pension fund exceed the actuarially computed value of plan liabilities. Since 1966, no charges have been required for pension costs, other than contributions to union pension plans, because recognized actuarial gains have exceeded the annual provisions for normal or current costs. Total pension costs charged to earnings, representing contributions to union plans, were $3,848,000 in 1976 and $3,342,000 in 1975.

Effective March 1, 1975, the Company made certain voluntary changes to its plan as well as certain other changes required by the Employee Retirement Income Security Act of 1974. The changes include improved employee benefits, a liberalization of eligibility requirements and accelerated vesting of plan benefits. It is estimated that the fund's assets were in excess of the actuarially computed value of vested benefits at March 27, 1976.

Note 10—Change in Accounting Method

During the third quarter of fiscal 1976, the Company changed its method of accounting for certain self-insured losses pursuant to Statements 5 and 11 of the Financial Accounting Standards Board. Under the previous method, a liability of $500,000 had been established and was charged annually when current uninsured losses exceeded a pre-defined amount. Under the new method, all such losses are charged to expense when incurred. The impact of this change was to increase previously reported net income and net income per share in 1975 by $66,000 and $.05, respectively and to eliminate the liability for such uninsured losses at the beginning of fiscal 1975 by crediting it to retained earnings.

Note 11—Litigation

In addition to various claims arising in the normal course of the Company's business, the Company has been named as one of several defendants, along with all other members of the National Association of Food

Notes to Financial Statements (continued)

Chains, in two of several actions filed by cattle producers. The actions allege violation of antitrust laws in the purchase and sale of meat. The actions in which the Company has been named seek damages in excess of $22,000,000 against all defendants, before trebling.

Although the lawsuits are in their early stages, based on the facts developed to date, management believes that both of the cases have no merit and that their ultimate resolution will not materially affect the Company's financial position.

Report of Independent Accountants

To the Board of Directors and Stockholders of First National Stores Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income (loss) and retained earnings and of changes in financial position present fairly the financial position of First National Stores Inc. and its subsidiaries at March 27, 1976 and March 29, 1975, and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied. Our examinations of these statements were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

PRICE WATERHOUSE & CO.

225 Franklin Street
Boston, Massachusetts 02110
May 11, 1976

Management's Discussion and Analysis of the Summary of Operations

The following discussion and analysis should be read in conjunction with the information provided in the Five Year Summary of Operations on Page 12.

Fiscal 1976 Compared to Fiscal 1975

Fiscal 1976 sales of $974,086,000 were $39,283,000 or 4.2% greater than in fiscal 1975. Sales during 1976 were affected favorably by continued growth in remodeled and identical stores, the opening of 5 new stores and, to a lesser degree, inflation. Sales were affected unfavorably by the first quarter 1976 strike and by the fact that the 61 stores closed during the two-year period contributed substantial sales to 1975.

Combined cost of sales, warehousing, transportation and store occupancy expenses improved slightly in fiscal 1976 compared to 1975 in relation to sales despite a non-recurring LIFO liquidation credit of $4,277,000 in 1975. Improvements registered in gross margins, primarily due to the relative price stability in fiscal 1976 of the products the Company sells, were offset by increased warehouse and transportation costs attributable to the strike and to increased operating costs which exceeded productivity gains.

Direct selling, advertising and general administrative expenses in relation to sales increased 1.2% in fiscal 1976 over fiscal 1975. Productivity gains at store level absorbed wage increases but not rapidly increasing employee benefit costs. In addition, the continued emphasis placed on store operations, merchandising programs and store condition resulted in increased costs. Advertising expenses also increased as a percentage of sales as the Company continued in fiscal 1976 the aggressive promotional programs begun in fiscal 1975.

Other income net of expense decreased $539,000 in 1976 primarily due to the lower amount of surplus cash available for investment as well as lower interest rates.

Net loss for fiscal 1976 was $1,502,000 which includes a credit for store closings of $1,173,000. Net income in fiscal 1975 was $5,774,000. The estimated credit relating to store closings was $449,000 in fiscal 1975, which also includes an extraordinary credit arising from the utilization of operating loss carryforwards of $1,595,000. In addition, net income for fiscal 1975 included a credit of $4,277,000 as a result of a reduction in inventory levels which caused the liquidation of LIFO inventory quantities. Estimated credits related to store closings are the result of recognizing gains on the disposal of closed stores in the period realized and from better than anticipated results experienced in disposing of closed store leases net of changes for additional planned store closings.

In fiscal 1975 the company was able to utilize a portion of its investment tax credit carryforward. Thus, the company's effective tax rate was 30%. In addition, utilization of net operating loss carryforwards resulted in an extraordinary credit of $1,595,000.

Fiscal 1975 Compared to Fiscal 1974

In fiscal 1975 sales of $934,803,000 were $75,205,000 or 8.7% above those of fiscal 1974. The net increase in sales was a function of three factors: 1.) the impact on selling prices of inflation, 2.) the effect of heavier promotion and better customer acceptance in identical stores; i.e., stores that were open for the full period 1974 and 1975, and 3.) the closing of 46 stores during the year.

Cost of sales was down by 1% in relation to sales between fiscal 1975 and fiscal 1974. Gross margins in 1975 were favorably impacted by the government's decontrol of prices in April, 1974. Controls had caused sales mix abnormalities resulting in reduced gross margins in 1974. Also, a reduction in inventory levels resulted in a credit to cost of goods sold of $4,277,000 in 1975 as described in Note 3 to the Financial Statements. Warehouse and transportation costs were lower in 1975 with overall cost control more than compensating for greatly increased fuel and supply expenses. Store occupancy costs improved due to increased volume per unit and the reduction in the number of operating stores.

Combined direct selling, advertising and general and administrative expenses in both fiscal 1975 and fiscal 1974 were approximately equal in relation to sales. However, direct selling and general and administrative expenses were reduced while advertising charges increased due to the company's more aggressive promotional programs.

Other income increased $780,000 in fiscal 1975 primarily due to improved interest income net of expense resulting from the investment of surplus cash in a more favorable market.

Net income in 1975 as previously discussed was $5,774,000. Net loss in 1974 was $14,924,000 after a charge related to store closings of $8,560,000. The charge to earnings in 1974 for estimated costs related to store closings was determined as described in Notes 2 and 4 to the Financial Statements, under an accounting policy adopted in fiscal 1974. Fiscal 1974 net loss also includes an extraordinary gain of $572,000 arising from the sale of land, and a charge of $1,964,000, the cumulative effect of the company's change in accounting for closed store expenses.

FIRST NATIONAL STORES INC.

Five Year Summary Of Operations (in thousands)

	Fiscal year ended				
	March 27, 1976	March 29, 1975	March 30, 1974	March 31, 1973	March 25, 1972
				(53 Weeks)	
Sales	**$ 974,086**	$ 934,803	$ 859,598	$ 849,316	$ 842,632
Costs and expenses:					
Cost of sales, warehousing, transportation and store occupancy expenses	**819,723**	790,220	735,148	717,737	712,553
Direct selling, advertising, general and administrative expenses	**150,802**	134,055	123,773	124,509	125,041
Depreciation and amortization	**7,450**	6,731	6,622	6,852	7,494
Estimated charges (credits) related to store closings	**(1,173)**	(449)	8,560	—	—
	976,802	930,557	874,103	849,098	845,088
Operating income (loss)	**(2,716)**	4,246	(14,505)	218	(2,456)
Other income (expense):					
Interest income	**1,367**	2,487	2,107	785	92
Interest expense	**(395)**	(933)	(1,242)	(856)	(379)
Other, net	**242**	199	108	514	(55)
	1,214	1,753	973	443	(342)
Income (loss) from continuing operations before income taxes	**(1,502)**	5,999	(13,532)	661	(2,798)
Federal and state income taxes	**—**	1,820	—	100	(1,345)
Income (loss) from continuing operations	**(1,502)**	4,179	(13,532)	561	(1,453)
Loss from discontinued operations, less applicable tax effect	**—**	—	—	(301)	(113)
Income (loss) before extraordinary items and before cumulative effect of change in accounting	**(1,502)**	4,179	(13,532)	260	(1,566)
Extraordinary items	**—**	1,595	572	(225)	877
Cumulative effect on prior years (to March 31, 1973) of change in method of accounting for costs related to store closings less $1,158 tax effect	**—**	—	(1,964)	—	—
Net income (loss)	**(1,502)**	5,774	(14,924)	35	(689)
Retained earnings at beginning of year, as previously reported					61,108
Add—Effect of change in accounting method (Note)					500
Retained earnings at beginning of year, as restated	**49,877**	45,010	59,934	59,899	61,608
Dividends declared	**(1,130)**	(907)	—	—	(1,020)
Retained earnings at end of year	**$ 47,245**	$ 49,877	$ 45,010	$ 59,934	$ 59,899
Per share of common stock:					
Income (loss) from continuing operations	**$ (1.32)**	$ 3.35	$ (9.86)	$ .41	$ (1.06)
Loss from discontinued operations	**—**	—	—	(.22)	(.08)
Income (loss) before extraordinary items and cumulative effect of change in accounting	**(1.32)**	3.35	(9.86)	.19	(1.14)
Extraordinary items	**—**	1.28	.41	(.16)	.64
Cumulative effect of change in method of accounting for store closings	**—**	—	(1.43)	—	—
Net income (loss)	**$ (1.32)**	$ 4.63	$ (10.88)	$ .03	$ (.50)
Shares outstanding for purposes of computing earnings per share	**1,136,632**	1,246,315	1,372,197	1,372,274	1,372,663
Cash dividends declared per share	**$ 1.00**	$ .75	—	—	$ .75
Pro forma amounts assuming the change in method of accounting for costs related to store closings had been applied retroactively:					
Loss from continuing operations			$ (13,532)	$ (227)	$ (1,133)
Per share of common stock			(9.86)	(.17)	(.83)
Loss before extraordinary items			(13,532)	(438)	(1,246)
Per share of common stock			(9.86)	(.32)	(.91)
Net loss			(12,960)	(618)	(369)
Per share of common stock			(9.45)	(.45)	(.27)

Note: Certain amounts as previously reported have been restated to reflect the retroactive application of the change in accounting for self-insurance.

Finast®

Directors

ALVIN P. BERNSTEIN, *Vice President—Finance and Treasurer of The Sperry and Hutchinson Company (a diversified trading stamp and furnishings company)*
WILLIAM T. FRENCH, *Chairman of the Board of Directors of the Company*
JOHN S. GRAHAM, *Business and Financial Consultant*
ALAN L. HABERMAN, *President and Chief Executive Officer of the Company*
LEWIS B. HARDER, *Chairman of the Board and Chief Executive Officer of International Mining Corp. (mining)*
DUNCAN O. McKEE, *Partner in Ballard, Spahr, Andrews & Ingersoll (attorneys)*
EDWARD A. MERKLE, *President of Madison Fund, Inc. (a closed-end investment company)*
WILLIAM B. O'KEEFFE, *Partner in Lyne, Woodworth & Evarts (attorneys)*
JACOB SALIBA, *President of Katy Industries, Inc. (diversified holding company)*
WESLEY A. STANGER, JR., *Director of McKay-Shields Financial Corp. (investment advisors)*

Officers

WILLIAM T. FRENCH, *Chairman of the Board*
ALAN L. HABERMAN, *President and Chief Executive Officer*
KERRY R. LYNE, *Senior Vice President, Secretary and General Counsel*
JOSEPH H. McCARTHY, *Senior Vice President—Supermarkets*
RICHARD L. KENNEY, *Vice President and Treasurer*
ROBERT E. NEMECEK, *Vice President—Personnel*
RICHARD M. O'KEEFFE, *Vice President—Corporate Store Operations*
THOMAS F. GRADY, *Controller*

Transfer Agent and Registrar

THE FIRST NATIONAL BANK OF BOSTON, *100 Federal Street, Boston, Massachusetts 02110*

Counsel

BALLARD, SPAHR, ANDREWS & INGERSOLL, *30 South 17th Street, Philadelphia, Pennsylvania 19103*

Independent Accountants

PRICE WATERHOUSE & CO., *225 Franklin Street, Boston, Massachusetts 02110*

Executive Offices

5 Middlesex Avenue, Somerville, Massachusetts 02143
Tel.: Area Code 617-623-2400

Distribution Centers

Somerville, Massachusetts
South Kearny, New Jersey

Finast®